

(c) *Periods for which an account is adequately diversified*—(1) *In general.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (*i.e.*, March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) *Start-up period.* (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is a real property account on its first anniversary shall be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2)(i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract, other than a pension plan contract (as defined in section 818 (a)), is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For purposes of this paragraph (c)(2), amounts transferred to the account from a diversified account (determined without regard to this paragraph (c)(2)) or as a result of an exchange pursuant to section 1035 in which the issuer of the contract received in the exchange is not

related in a manner specified in section 267(b) to the issuer of the contract transferred in the exchange are not treated as—

(A) Amounts attributable to contracts entered into more than one year before such date, in the case of accounts subject to paragraph (c)(2)(i) of this section, or

(B) Amounts attributable to contracts entered into more than five years before such date, in the case of accounts subject to paragraph (c)(2)(ii) of this section.

(3) *Liquidation period.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) *Market fluctuations.* A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(e) *Segregated asset account.* For purposes of section 817(h) and this section, a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. See paragraph (g) for examples illustrating the application of this paragraph (e).

(f) *Look-through rule for assets held through certain investment companies, partnerships, or trusts*—(1) *In general.* If this paragraph (f) applies, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a trust that is

treated under sections 671 through 679 as owned by the grantor or another person ("investment company, partnership, or trust") shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. For purposes of this section, the ratable interest of a partner in a partnership's assets shall be determined in accordance with the partner's capital interest in the partnership.

(2) *Applicability*—(i) *Certain investment companies, partnerships, and trusts.* This paragraph (f) shall apply to an investment company, partnership, or trust if—

(A) All the beneficial interests in the investment company, partnership, or trust (other than those described in paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(B) Public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract. Solely for this purpose, the status of a contract as a variable contract will be determined without regard to section 817(h) and this section.

(ii) *Nonregistered partnerships.* This paragraph (f) shall also apply to a partnership interest if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities.

(iii) *Trusts holding Treasury securities.* This paragraph (f) shall also apply to a trust that is treated under section 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

(3) *Interests not held by segregated asset accounts.* Satisfaction of the requirements of paragraph (f)(2)(i) of this section shall not be prevented by reason of beneficial interests in the investment company, partnership, or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in

section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company, partnership, or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership, or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan; or

(iv) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81-225, 1981-2 C.B. 12, but only if (A) the investment company, partnership, or trust was closed to the public in accordance with Rev. Rul. 82-55, 1982-1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

(g) *Examples.* The provisions of paragraphs (e) and (f) of this section may be illustrated by the following examples.

Example 1. (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and (b) interests in P, a partnership that is publicly registered. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available exclusively through the purchase of a variable contract. The variable contracts provide

that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of paragraph (b) of this section.

(ii) As a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, under paragraph (e) of this section, the interests in P are treated as part of a single segregated asset account ("Account 1") and the debt securities are treated as part of a different segregated asset account ("Account 2").

(iii) Since P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P.

(iv) Since Account 1 and Account 2 each satisfy the requirements of paragraph (b) of this section, variable contracts that are based on either or both accounts are treated as annuity, endowment, or life insurance contracts.

Example 2. The facts are the same as in example 1 except that some of the beneficial interests in P are held by persons not described in paragraph (f)(3) of this section. Since P is not described in paragraph (f)(2) of this section, interests in P will be treated as a single investment of Account 1. As a result, Account 1 does not satisfy the requirements of paragraph (b) of this section. Variable contracts based in whole or in part on Account 1 are not treated as annuity, endowment, or life insurance contracts. Variable contracts that are not based on Account 1 at any time during the period in which such account fails to satisfy the requirements of paragraph (b) of this section (*i.e.*, contracts based entirely on Account 2), are treated as annuity, endowment, or life insurance contracts. See paragraph (a)(1).

Example 3. The facts are the same as in example 2 except that P is not publicly registered. Since P is described in paragraph (e)(2)(ii) of this section, the result is the same as in example 1.

Example 4. The facts are the same as in example 2 except that the variable contracts do not permit policyholders to allocate premiums between or among the debt securities and interests in P. Thus, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Under paragraph (e) of this section, the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P and the debt securities, considered together,

satisfy the requirements of paragraph (b) of this section, contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

(h) *Definitions.* The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) *Government security*—(i) *General rule.* The term *government security* shall mean any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. Any security or certificate of deposit insured or guaranteed only in part by the United States or an instrumentality thereof is treated as issued by the United States or its instrumentality only to the extent so insured or guaranteed, and as issued by the direct obligor to the extent not so insured or guaranteed. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a-2 (16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(ii) *Example.* A segregated asset account purchases a certificate of deposit in the amount of \$150,000 from bank A. Deposits in bank A are insured by the Federal Deposit Insurance Corporation, an instrumentality of the United States, to the extent of \$100,000 per depositor. The certificate of deposit is treated as a government security to the extent of the \$100,000 insured amount and is treated as a security issued by bank A to the extent of the \$50,000 excess of the value of the certificate of deposit over the insured amount.

(2) *Treasury security*—(i) *General rule.* For purposes of paragraph (b)(3) of this section and section 817(h)(3), the term *Treasury security* shall mean a security the direct obligor of which is the United States Treasury.

(ii) *Example.* A segregated asset account purchases put and call options on U.S. Treasury securities issued by the Options Clearing Corporation. The

options are not Treasury securities for purposes of paragraph (b)(3) and section 817(h)(3) because the direct obligor of the options is not the United States Treasury.

(3) *Real property.* The term *real property* shall mean any property that is treated as real property under 1.856-3 (d) except that it shall not include interests in real property.

(4) *Real property account.* A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter. A segregated asset account will also be treated as a real property account on its first anniversary if on or before such first anniversary the issuer has stated in the contract or prospectus or in a submission to a regulatory agency, an intention that the assets of the account will be primarily invested in real property or interests in real property, provided that at least 40% of the total assets of the account are so invested within six months after such first anniversary.

(5) *Commodity.* The term *commodity* shall mean any type of personal property other than a security.

(6) *Security.* The term *security* shall include a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any other partnership interest, any interest in real property, or any interest in a commodity.

(7) *Interest in real property.* The term *interest in real property* shall include the ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include min-

eral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interest in real property" also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity.* The term *interest in a commodity* shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value.* The term *value* shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851.* To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions.* (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77-85, 1977-1 C.B. 12, or Rev. Rul. 81-225, 1981-2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instruments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States

shall not be treated as government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

[T.D. 8242, 54 FR 8730, Mar. 2, 1989; T.D. 8242, 54 FR 11866, Mar. 22, 1989]

§ 1.818-1 Taxable years affected.

Sections 1.818-2 through 1.818-8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2785, Apr. 4, 1961 as amended by T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.818-2 Accounting provisions.

(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sec-

tions 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(3)(i) An election to use any of the special methods of accounting referred

to in subparagraph (2) of this paragraph which was made pursuant to any provisions of the Internal Revenue Code of 1954 or prior revenue laws for purposes of determining a company's tax liabilities for prior years, shall have the same force and effect in determining the items of gross investment income under section 804(b) and the items of deduction under section 804(c) of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) as if such Act had not been enacted.

(ii) For purposes of determining gain or loss from operations under section 809(b), in computing the life insurance company's share of investment yield under section 809(b) (1)(A) and (2)(A), an election with respect to any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provision of the Internal Revenue Code of 1954 or prior revenue laws, shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

(iii) For purposes of determining gain or loss from operations under section 809(b), in computing the items of gross amount under section 809(c) and the deduction items under section 809(d), an election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph must be made in accordance with the specific statutory provisions of the sections containing such elections and the regulations thereunder. However, where a particular election may be made only with the consent of the Commissioner (either because the time for making the election without the consent of the Commissioner has expired or because the particular section contained no provision for making an election without consent), and the time prescribed by the applicable regulations for submitting a request for permission to make such an election for the taxable year 1958 has expired, a life insurance company may make such an election for the year 1958 at the time of filing its return for that year (including extensions thereof). For example, a life insurance company may elect any of the methods of depreciation prescribed in section 167 (to the extent permitted under that section and the regulations

thereunder) with respect to those assets, or any portion thereof, for which no depreciation was allowable under prior revenue laws, for example, furniture and fixtures used in the underwriting department. Similarly, a life insurance company shall be permitted to make an election under section 461(c) (relating to the accrual of real property taxes) with respect to real property for which no deduction was allowable under prior revenue laws. Any such election shall be made in the manner and form prescribed in the applicable regulations.

(iv) For purposes of subdivision (ii) of this subparagraph, the method used under section 1016(a)(3)(C) (relating to adjustments to basis) in determining the amount of exhaustion, wear and tear, obsolescence, and amortization actually sustained shall not preclude a taxpayer from electing any of the methods prescribed in section 167 in accordance with the provisions of that section and the regulations thereunder for determining the amount of such exhaustion, wear and tear, obsolescence, and amortization for the year 1958. For example, if the amount of depreciation actually sustained, under section 1016(a)(3)(C), on a life insurance company's home office building (other than that portion for which depreciation was allowable under prior revenue laws) is determined on the straight line method, the life insurance company may elect for the year 1958 to use any of the methods prescribed in section 167 for determining its depreciation allowance for 1958. However, such election shall be binding for 1958, and for all subsequent taxable years, unless consent to change such election, if required, is obtained from the Commissioner in accordance with the provisions of section 167 and the regulations thereunder.

(4)(i) For purposes of section 805(b)(3)(B)(i) (relating to the determination of the current earnings rate for any taxable year beginning before January 1, 1958), the determination for any year of the investment yield and the assets shall be made as though the taxpayer had been on the accrual method prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with

the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in determining the investment yield and assets for the taxable year 1958. However, where the method used for determining the deduction under section 167 for the year 1958 differs from the method used in prior years, the amount of the deduction actually allowed or allowable for such prior years for purposes of section 1016(a)(2) (relating to adjustments to basis) shall be the amount to be taken into account in determining the current earnings rate under section 805(b)(3)(B)(i).

(ii) For purposes of section 812(b)(1)(C) (relating to operations loss carrybacks and carryovers for years prior to 1958), the determination for those years of the gain or loss from operations shall be made as though the taxpayer had been on the accrual method of accounting prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in the determination of gain or loss from operations for the taxable year 1958. However, where any adjustment to basis is required under section 1016(a)(3)(C) on account of exhaustion, wear and tear, obsolescence, amortization, and depletion sustained, the amount actually sustained as determined under section 1016(a)(3)(C) for each of the years involved shall be the amount allowed in the determination of gain or loss from operations for purposes of section 812(b)(1)(C).

(b) *Adjustments required if accrual method of accounting was not used in 1957.* The items of gross amount taken into account under section 809(c) and the items of deductions allowed under section 809(d) for the taxable year 1958 shall be determined as though the taxpayer had been on the accrual method of accounting prescribed in paragraph (a) of this section for all prior years. Thus, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of gross amount which would have been properly taken into

account for the year 1957 if the company had been on the accrual method described in section 818(a). Likewise, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of deductions which would have been properly allowed for the year 1957 if the company had been on the accrual method described in section 818(a). For example, if certain premium amounts were received during the year 1958 but such amounts would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be required to take such premium amounts into account for the year 1958. If, for example, certain claims, benefits, and losses were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818-6.

(c) *Change of basis in computing reserves.* (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for determining any item referred to in section 810(c) as of the close of any taxable

year differs from the basis for such determination as of the close of the preceding taxable year. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be made and the amount of any increase (or de-

crease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, Apr. 4, 1961]

§ 1.818-3 Amortization of premium and accrual of discount.

(a) *In general.* Section 818(b) provides that the appropriate items of income, deductions, and adjustments under part I, subchapter L, chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) *Acquisitions before January 1, 1958.*

(1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value.